STATEMENT OF
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BEFORE THE
COMMITTEE ON GOVERNMENT REFORM

SUBCOMMITTEE ON ENERGY AND RESOURCES

UNITED STATES HOUSE OF REPRESENTATIVES

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Mr. Chairman and Members of the Subcommittee, I appreciate the opportunity to appear here today. My name is Greg Pilcher, and I am Senior Vice President, General Counsel, and Corporate Secretary of Kerr-McGee Corporation ("Kerr-McGee").

As requested in your invitation to testify, my testimony will discuss royalty relief for production of oil and natural gas in the Gulf of Mexico pursuant to the Deep Water Royalty Relief Act of 1995, Public Law 104-58 ("the Act") and certain aspects of the administration of such royalty relief by the Department of the Interior ("Interior"). In particular, you have requested Kerr-McGee to address the absence of so-called price triggers from deep water leases that Interior issued to companies in 1998 and 1999.

Kerr-McGee has been leasing properties and exploring for oil and gas in the Gulf of Mexico since 1938. We are proud to have been and to remain at the forefront of deep water exploration and development. In 2005, we had 510 deepwater leases covering more than 3 million acres of seafloor. Kerr-McGee has invested over \$3.5 billion in deep water operations, including installing the world's first cell spar in 2004.[1] For 2006, we have budgeted approximately \$650 million in capital expenditures and exploration expense for the deep water Gulf of Mexico. Since 1999, Kerr-McGee has made 19 deep water discoveries, including 3 already in 2006. We produce more than 95,000 barrels of oil equivalent per day of net production from the deep water Gulf of Mexico to help supply America's energy needs.

As the members of this Subcommittee may be aware, a subsidiary of Kerr-McGee currently is engaged in a lawsuit in federal court to resolve a dispute between the Company and Interior. That lawsuit concerns Interior's assertion that the agency has discretion to impose conditions on the royalty relief that the 104th Congress provided in the Act. Although I am not at liberty to discuss confidential opinions of counsel, attorney work product, or other privileged information about the lawsuit, I will discuss Kerr-McGee's publicly-stated positions about that legal dispute.

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[1] These costs include over \$450 million spent on upfront cash bonuses paid to the U.S. Government to acquire and cash rentals to preserve deep water leases in the Gulf of Mexico, over \$2.5 billion in well and other capital costs, and over \$400 million in dry hole costs.

Background, Objectives, and Success of the Act

In 1995, enactment of the Act served to promote investment in the capital-intensive and high risk oil and gas operations in deep water areas of the Gulf of Mexico. To attract such investment, the Act unconditionally guaranteed each company that accepted a deep water lease from the federal government during the first five years after enactment—from 1996 through 2000—the right to produce "not less than" a statutorily defined volume of oil and natural gas without a royalty obligation on that volume, before paying royalties at the regular rate on any additional volumes produced from those leases.

As an incentive program, deep water royalty relief applied to projects that were, by their very nature, long-term investments. It is not uncommon for 5 or 6 years, or more, to pass between the issuance of a lease and the recovery of hydrocarbons from a discovery. Moreover, when discoveries are made, production can go on for many years. This long-term process means that the benefits of the incentive program, for both the companies and the public, will not be immediately achieved. It also means that the companies who receive the incentive are factoring it into long-term planning for the lives of their projects.

The offshore oil and gas industry was beleaguered in the early 1990s by many challenges. Production in the Gulf of Mexico was declining, oil companies were investing large portions of their drilling budgets overseas, and hundreds of thousands of domestic jobs in the industry had been slashed. (*See* Senate Report 103-248 (Apr. 11, 1994), examining in detail the dramatic decline in oil and gas production on the Outer Continental Shelf in the early 1990s and the costs involved in deep water exploration and production.) The Act was enacted in response to those developments, and to serve as a catalyst to help address our country's dependence on foreign oil. The legislative history of the Act demonstrates that the 104th Congress sought to increase investment in new drilling in the Gulf of Mexico, increase the domestic energy supply, and create jobs in an industry that was reeling from job losses. For example, Representative Bob Livingston stated:

> [T]he United States is now importing 50 percent of our energy needs. The Department of Energy projects 60 percent import level by 2010. The United States has lost 450,000 jobs in the oil and gas industry. The temporary royalty relief in [Senate Bill] 395 will enable the private sector to risk its own funds to find and produce domestic oil and gas to enhance national energy security and create jobs.[2]

(141 Cong. Rec. at H11856 (Nov. 8, 1995) (Rep. Livingston).)

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[2] See also 141 Cong. Rec. at H11857 (Nov. 8, 1995) ("These provisions will create jobs in the energy industry and further limit our reliance on foreign oil") (Rep. Ken Bentsen); 141 Cong. Rec. at H11859-60 (Nov. 8, 1995) (emphasizing job creation and increasing domestic energy supply) (Rep. Bill Brewster); 141 Cong. Rec. at 11860-61 (Nov. 8, 1995) (same) (Rep. W.J. "Billy" Tauzin); 141 Cong. Rec. at H11868 (Nov. 8, 1995) (same) (Rep. Sheila Jackson-Lee); 141 Cong. Rec. at H11878-79 (same) (Rep. Bill Richardson).

Although granting relief from some royalty obligations would decrease royalty revenues, the 104th Congress recognized that, in addition to the benefits of encouraging deep water exploration to support the domestic industry and to reduce dependence on foreign sources of energy, the sale of leases entitled to royalty relief also could be expected to generate increased upfront cash bonus dollars that companies pay at the outset, regardless of exploration success, to acquire new leases. For example, Secretary of Energy Hazel O'Leary stated to Congress that the royalty relief provisions of the Act were expected to lead to an increase of bonus payments of nearly one-half billion dollars ($485 million). (Conf. Rep. on S. 395, 141 Cong. Rec. H11854-01, at H11872 (letter from Energy Secretary O'Leary).)

Now a decade later, it is evident that the Act has been an enormous success.

In the ten federal offshore lease sales held during the period 1996 through 2000, Interior granted nearly 4,000 new deep water leases, generating record bidding and cash bonus payments to the United States. For example, Lease Sale No. 166, held in March 1997, generated more than 1,000 bids, including $40 million in bids on lease tracts that Interior had previously refused to lease because prior bids were too low. In contrast to the prediction that the Act would lead to $485 million in increased bonuses for the next 5 years, Interior has estimated that "the government received approximately $2 billion more in bonus payments in the lease sales held from 1996 to 2000 than it would have received had the leases been offered without royalty relief." (Statement of Walter Cruikshank, Deputy Director, MMS, Before the Committee on Government Reform, Subcommittee on Energy and Resources, March 1, 2006 ("Cruikshank Statement"), at p. 3.)

Moreover, Interior has noted that, although companies bid for fewer than 150 deep water tracts in 1993 and 1994 combined, they bid on 877 tracts in 1996 and 1,280 tracts in 1997. (Rose, Farndon & Fraser, "Design and Rationale of the Final Rule on the Deep Water Royalty Relief Act, p. 2 (Interior, MMS, Offshore Technology Conference Paper 8710 (May 1998).)

The Act's success was not limited to generating increased bidding on offshore leases. With regard to the goal of increasing energy production in the deep waters of the United States, MMS's Regional Director for the Gulf of Mexico has stated that development since the Act "has succeeded probably beyond the most optimistic dreams of most of us." (Interior, OCS Report MMS 2004-021, "Deepwater Gulf of Mexico 2004: America's Expanding Frontier," May 2004, at p. xi (preface of Chris C. Oynes).) Industry has drilled more than 980 exploration wells in deepwater areas of the Gulf of Mexico since 1995 and announced more than 125 deepwater discoveries. (Interior, OCS Report MMS 2006-022, "Deepwater Gulf of Mexico 2006: America's Expanding Frontier," May 2006, at p. xi (preface).) By the end of 2002, daily hydrocarbon production from the deep waters of the Gulf of Mexico had increased from 1995 levels by 535% for oil and 620% for natural gas. (OCS Report MMS 2004-021, at p. xi.) By year-end 2002, companies were producing an estimated 959,000 barrels of oil per day and 3.6 billion cubic fee of natural gas each day. (*Id.*) According to Interior, by 2004, deep water production "accounted for over 67 percent of the oil (362 million barrels) and 37 percent of the natural gas (1.5 trillion cubic feet)" produced from the Gulf of Mexico. (Cruikshank Statement, p. 3.)

Furthermore, Interior has determined that deepwater development has generated tens of billions of dollars in onshore economic activity and provided tens of thousands of jobs. (*See* Interior, OCS Study MMS 2001-019, "Lafourche Parish and Port Fourchon, Louisiana: Effect of the Outer Continental Shelf Petroleum Industry on the Economy and Public Services, Part 1," May 2001; Interior, OCS Report MMS 2004-021.)

The Importance of Deep Water Royalty Relief

The deep water of the Gulf of Mexico is a very challenging and costly environment for the oil and gas industry. The leases governed by the Act are located where the ocean is at least 200 meters (about 650 feet) deep, and many of Kerr-McGee's projects are in waters more than 3,000 feet deep. Our Red Hawk project is located in approximately 5,300 feet of water—about one mile deep. Thus, in order to discover and, where possible, recover hydrocarbons, we have to overcome deep ocean currents and other challenges even before drilling into the Earth. Moreover, we all have been reminded in recent years of the threat of hurricanes and tropical storms in the Gulf. Hurricanes Ivan, Katrina, and Rita, for example, all interfered at times with deep water operations.

These challenges and the innovative technology required to overcome them make deep water operations very expensive. Exploration wells in the deep water cost tens of millions of dollars each. When exploration finds hydrocarbons in producing quantities, hundreds of millions of dollars of additional infrastructure are required for production. In contrast to the fixed leg platforms for shallow waters, most of Kerr-McGee's deep water production occurs through floating spars, in some cases more than 100 miles from shore and, as I said, as much as a mile above the ocean floor.

Not surprisingly, deep water projects take a long time to implement. Once a deep water lease is accepted, several years typically pass before an exploration well is drilled and, if hydrocarbons are discovered, installation of production facilities typically takes 2 to 3 more years. Such long lead times are problematic in a cyclical industry where prices can vary over time—the present day's commodity prices cannot be counted on when production starts years later. As I mentioned before, investment decisions therefore have to be made with a long-term horizon in mind. Among the only factors that a company should expect to count on remaining stable during the long life of such an offshore project are the legally-mandated rules that apply to the offshore lease.

Although companies have drilled hundreds of exploration wells in deepwater areas of the Gulf of Mexico since 1995, with some notable successes, the vast majority—over 80%—have not led to announced discoveries of oil or gas sufficient to support production. Kerr-McGee alone has incurred over $400 million in dry hole costs in the deep water of the Gulf of Mexico.

In the event of a dry hole, where the investment of up to $100 million in a single deep water well fails to find hydrocarbons, the leasing company and its working interest partners must absorb the entire cost of the failed project. In such instances, there is no refund of the millions of dollars in bonuses paid to the U.S. Treasury to obtain the lease, no revenues from production, no basis for paying royalties, and, obviously, no royalty relief.

When exploration is successful, royalty relief for initial production helps the company to recover its massive investment in that project, as well as in failed projects in the deep water. I note, however, that royalty relief for leases issued from 1996 through 2000 applies only to statutorily-defined volumes produced from those leases. (Those volumes vary, depending on the water depth at the lease.) Once production from a deep water lease exceeds the specified minimum volume, and the company has received the expected incentive under the Act, then the company has the obligation to pay royalties to the government on additional volumes at the usual rate.

The Leasing Process

Prior to submitting a sealed bid at an Outer Continental Shelf lease sale, Kerr-McGee evaluates each tract offered at the sale, and considers the geology of the tract—and the associated potential for discovering hydrocarbons—as well as the costs of drilling exploratory wells at that location and depth and, if sufficient hydrocarbons are discovered, the likely costs of production facilities and related infrastructure.

When companies are interested in an offshore tract offered by Interior, they submit sealed bids to the agency that specify the upfront cash bonus that they are willing to pay to the federal government to obtain the lease for that tract. The high bidder, assuming that it satisfies Interior that the bid meets the requirements for a fair return for the lease rights granted and it is qualified in the sense of having the resources and expertise necessary to operate in that environment, will be offered the lease. It is worth emphasizing that the upfront cash bonus offered by a bidder is the only term of the contract that is determined by the company. The form of the lease, including its royalty language, is dictated by Interior and companies are not given an opportunity to negotiate about the terms and conditions of that form.

Interior, however, must act in accordance with applicable law, including the Act. Indeed, the standard Interior offshore lease expressly provides in Section 1 of the contract that the lease is subject to the Outer Continental Shelf Lands Act (of which the Deep Water Royalty Relief Act is a part) and implementing regulations in effect at the time the lease is issued.[3] Thus, the applicable law is part of the contract itself. The only opportunity, however, a company has to object to unlawful provisions in the form of lease offered to successful bidders by Interior is to follow the rules imposed by Congress through the Administrative Procedure Act and the implementing regulations adopted by Interior. If

[3] *See Mobil Oil Exploration & Producing Southeast, Inc. v. United States*, 530 U.S. 604, 609, 616-20 (2000) (holding that Section 1 means that, as part of the contract between the government and the company, such offshore leases are not subject to later changes in the law, except for the narrow category of future changes specified in that section).

Interior never sought to enforce an unlawful provision in its lease form, a challenge to that provision would not be ripe; the issue would be moot.

Consistent with the bidding process I have just described, including applicable law and agency regulations, there are no negotiations, as such, for lease terms. After inquiring, I am not aware of any discussion Kerr-McGee had with Interior about the form of the deep water leases issued during the 5-year period from 1996 through 2000. If any other business or group sought to engage in discussions with Interior about the form of those deep water leases, I am not aware of such discussions.

Instead, and consistent with Interior's administrative review procedures, Kerr-McGee used Interior's administrative review process in a timely way to challenge unlawful provisions included in the leases when Interior sought to enforce these unlawful provisions. I have been informed that several other independent exploration and production companies that operate in the Gulf of Mexico also have pursued administrative appeals from Interior efforts to enforce the same provisions. As far as I am aware, however, Kerr-McGee is the only company that has received a final agency decision concerning price triggers, allowing for judicial review.

The Absence of Price Triggers From 1998 and 1999 Deep Water Leases Is Consistent with the Act and Interior's Implementing Regulations

Kerr-McGee believes it is clear that the 104th Congress did not give Interior discretion or authority to include price triggers in any leases sold during the 5-year period after the passage of the Act. Thus, the absence of price triggers from the leases awarded in 1998 and 1999 does not appear to be a mistake; to the contrary, the absence of price triggers was necessary in order for those leases to be consistent with the law.

Kerr-McGee's understanding of the applicable law is informed by a decision of the United States Court of Appeals for the Fifth Circuit styled *Santa Fe Snyder Corporation vs. Norton*. We believe that the absence of price triggers from leases issued in 1998 and 1999 is consistent with and, indeed, mandated by that court's interpretation of the Act.

In interpreting and applying the Act, the district court in that case ruled that—

> Section 304 [of the Act] mandates that, without exception, based only on the objective factors of water depth, location of the lease block and date of the lease sale [during the 5 years after enactment], all leases meeting these objective criteria are entitled to receive the suspensions of royalties benefit, which the Secretary may not set at a volume less than the particular volume assigned for each water depth. The statute is unambiguous on this point.

(*Santa Fe Snyder Corp. v. Norton*, No. 2:00-CV-1641, opinion at p. 9 (W.D. La. Jan. 8, 2003).) On appeal, the court of appeals agreed with and affirmed that interpretation of the Act. (*Santa Fe Snyder Corp. v. Norton*, 385 F.3d 884, 892 (5th Cir. 2004).) Thus, as interpreted by the courts, although Section 303 of the Act gave Interior certain discretion to condition royalty relief for many leases, Section 304 of the Act "replaces Interior's discretion with a fixed royalty suspension for New Leases [that is, sold from 1996 through 2000] on a volume basis …." (*Id.*)

Interior's own published regulations support this conclusion. When Interior published regulations governing leases sold from 1996 through 2000, the agency did not include in those regulations any provision concerning price triggers. (*See* 30 C.F.R. §§ 260.110 through 260.117.) In contrast, when Interior published regulations for leases sold before 1996 and after 2000, those regulations explicitly addressed the inclusion and effect of price triggers for such earlier and later leases. (30 C.F.R. §§ 203.78, 260.122.) It is important to note that the establishment and publication in the Federal Register of such agency regulations is not a haphazard effort. To the contrary, compliance with the Administrative Procedure Act and agency protocols require careful deliberation and opportunities for public comment. In this case, Interior did not publish its final regulation governing leases sold from 1996 through 2000 until January 1998. (63 Fed. Reg. 2626 (Jan. 16, 1998), publishing 30 CFR § 260.110 *et seq*.) As I noted, when Interior did so, the agency did not provide for price triggers for such leases, including those sold during 1998 and 1999. We believe, in this respect, the resulting regulations were consistent with the Act.

Notably, shortly after Interior finalized its regulations in January 1998, which govern deep water leases sold from 1996 through 2000, Interior stopped inserting the unlawful price trigger language in its leases. Thus, from outside the agency, it certainly appears that the absence of price thresholds from 1998 and 1999 leases is consistent with and quite possibly the result of Interior's well-reasoned conclusion, through the rule-making process, that the Act did not allow Interior unilaterally to impose conditions on the royalty relief mandated by the 104th Congress.

Furthermore, the legislative history of the Act strongly supports the conclusion that the 104th Congress did not intend to give Interior discretion to impose conditions such as price triggers on deep water royalty relief for a 5-year period. In 1995, Senator Bennett Johnston introduced S. 158, which proposed royalty relief for deepwater leases. That bill had no provision that would limit royalty relief by price triggers. Discussion of that bill during a hearing before the Senate Committee on Energy and Natural Resources on March 23, 1995, emphasized the concern of the bill's proponents that Interior have as little discretion as possible in the allowance of a royalty suspension volume for leases issued during the first 5 years.

Two witnesses for the Clinton Administration, the Deputy Secretary of Energy and the Assistant Secretary of the Interior, agreed that they did not read S.158 to give Interior discretion to alter the minimum suspension volumes provided for new leases. Instead, both agreed that the bill simply provided that "all new leases offered in deep-water portions of the Central and Western Gulf of Mexico for the next 5 years would include royalty suspensions on initial production as specified in the bill." (Statement of Asst. Secretary Bob Armstrong, "Outer Continental Shelf Impact Assistance and Deep Water Royalty Relief Act," Hearing before the Committee on Energy and Natural Resources, United States Senate, on S. 158 and S. 575, 104th Cong., 1st Sess. 13 (1995); *see also id.* at 57 (essentially identically worded statement of Deputy Secretary William H. White).)

Remarks at the same hearing by Senators Johnston and Don Nickles and Committee Chairman Frank Murkowski all stressed that, to use Senator Johnston's phrase, "if we can take all the discretion out of it [royalty relief], so much the better." (*Id.* at p. 40; *see also id.* at 9 (remarks of Sen. Nickles) ("I think maybe we might want to . . . take away some of that discretion"); *id.* at p. 41 (remarks of Sen. Murkowski) (skeptical of leaving too much discretion with the Secretary).)

The deep water royalty relief provisions of S. 158 came to be incorporated into S. 395 and passed by the Senate on May 16, 1995. Upon consideration of S. 395, however, the House of Representatives struck those royalty relief provisions. The two bills went to a conference committee, which restored the Senate's provisions. (H.R. Rep. 104-312, 104th Cong., 1st Sess., 8-11 & 19 (1995) (conference report).)

In urging adoption of the conference report on the Act, Senator Johnston explained how royalty relief would be granted for leases issued in the first 5 years after enactment.

> This provision is straightforward. For the next 5 years, deep water leases will be offered for sale under the following terms: First, payment of an upfront bonus bid, and second, waiver of the royalty on a fixed volume of oil and gas based on the water depth of the lease.

(141 Cong. Rec. S17023 (1995).)

In the House, Representative George Miller of California, who opposed the conference report, made essentially the same point:

> Under the language of the conference report, all leases in more than 200 meters must be granted on a royalty-free basis for the next 5 years with no finding of need even though that need is the only rationale for granting the royalty holiday in the first place. Don't let anyone tell you the royalty holiday is discretionary for new leases.

(Cong. Rep. on S. 395, 141 Cong. Rec. H11854-01, at H11875-76 (Nov. 18, 1995).)[4]

With these stated explanations of how royalty relief pursuant to the Act would operate for leases sold during the next 5 years, the 104th Congress passed the Act by wide margins in both chambers.

[4] *See also* 141 Cong. Rec. at H7584 (July 25, 1995) ("This takes discretion away from the Secretary") (Rep. Miller); 141 Cong. Rec. at H11857 (Nov. 8, 1995) ("The problem with this is, it is mandatory.") (Rep. Miller); 141 Cong. Rec. at H11868 (Nov. 8, 1995) ("This is an entitlement for the next five years because this is mandatory. This is not discretionary.") (Rep. Miller).

In sum, the plain language and the legislative history of the Act indicate that Interior lacked authority to impose price triggers for leases issued during a 5-year period that included 1998 and 1999. It appears from the agency's regulations that Interior had reached the same conclusion by January 1998, when it published final rules to govern these leases. Thus, Kerr-McGee does not regard the absence of price triggers from the 1998 and 1999 leases to have been a mistake.

Our Working Relations with MMS

Kerr-McGee has a good professional working relationship with Interior and its MMS division. The professionals employed by Interior are knowledgeable, competent, and hard working.

Kerr-McGee works diligently to comply with all of Interior's regulations and all applicable federal laws, and has an outstanding record in that regard. Kerr-McGee has received from MMS the "SAFE Award" on numerous occasions. In fact, Kerr-McGee has been a finalist or the recipient of the SAFE Award 7 out of 8 years. Additionally, in 1997 and 1998 Kerr-McGee received from MMS the Conservation Award for Respecting the Environment (CARE) for the Gulf of Mexico.

That does not mean that Kerr-McGee has not, on occasion, had grounds for disagreeing with certain MMS actions or taking issue with Interior's legal positions on some issues. The calculation of royalties, for example, is a complex question that depends on a variety of inputs concerning the value of production and the deductions permissible under law. Disputes can arise when there is uncertainty or occasional error concerning those inputs.

When such disputes with Interior have arisen, however, we feel that they have been addressed in a professional manner. In some cases, such uncertainties and disputes can be resolved through agreements in which both the Company and the agency compromise, thus conserving resources that otherwise would be expended on litigation rather than finding common ground. In other cases, administrative appeal processes within the agency have resolved disputes between Kerr-McGee and Interior. (*See*, *e.g.*, *Kerr-McGee Corp.*, 147 IBLA 277 (Dep't of Interior, Off. of Hrgs. & Appeals, Interior Bd. of Land Appeals (Jan. 29, 1999) (overruling Kerr-McGee's position on royalty calculations for certain offshore production).) In still other cases, as in the *Santa Fe Snyder* lawsuit, both Interior and Kerr-McGee have stood fast in their respective good faith positions in the controversy, and the judicial system has served as a neutral arbiter to perform its duty, as Chief Justice John Marshall said 200 years ago, "to say what the law is." (*Marbury v. Madison*, 5 U.S. 137, 177 (1803).)

Conclusion

We believe that the Act should be recognized as a tremendous success. The Act is responsible for encouraging the very investment and resulting increase in domestic production of oil and gas that are so critical to our nation's energy supply. Indeed, we believe the American people should praise the foresight of the 104th Congress in 1995 to encourage deep water exploration efforts, which have only just begun to bear fruit to provide important new domestic energy sources.

With regard to price triggers for royalty relief for leases issued during 1996 through 2000, Kerr-McGee believes that the absence of price triggers from leases issued in 1998 and 1999 was not a mistake, but rather necessary for those leases to comply with the Act. For other leases issued during that period, Kerr-McGee has a dispute with Interior that has become ripe for judicial review. It is a foundational principle of our system of government that an independent judiciary exists to resolve disputes both among private parties, and between individuals and their government. Although we believe it is clear that the legislation passed by the 104th Congress applies to price triggers in the manner I have discussed, since Interior now takes a contrary position, under our system of government such disputes ultimately are to be resolved by the courts. We hope that Congress will permit the judicial system to do its work and to permit the underlying dispute to be resolved according to the rule of law and in a manner consistent with traditional notions of fair play and substantial justice.

Mr. Chairman, thank you again for carefully considering the issues we lay out today. We share your commitment to working to increase America's domestic oil supplies in an effort to bring down energy costs and dependence on foreign sources. We stand ready to work with the Committee as you continue your investigation of this important issue.